

PHILIP MORRIS U.S.A.

INTER-OFFICE CORRESPONDENCE

120 PARK AVENUE, NEW YORK, N.Y. 10017

TO: Distribution

DATE: September 10, 1993

FROM: M. E. Szymanczyk

SUBJECT: **K-MART**

This recaps the outcome of today's meeting with K-Mart at their headquarters in Troy, Michigan. Attending the meeting for PM-USA were Brian Schuyler, Barry Hopkins, Jim Sudzik (K-Mart National Account Manager), Jackie Gilbert (Assistant General Council) and myself. Attending for K-Mart were Glenn Smith - Executive VP, Merchandising, Jim Kelly - VP Merchandising, Don Williams - Buyer, Reggie Mears - Head Buyer, Tom Douns - VP Operations, George Shirpes - Director Operations, and Bill Underwood - Senior VP Merchandising.

The purpose of the meeting was to discuss/resolve the issues regarding Retail Masters raised in Glenn Smith's July 28, 1993 letter to Mike Miles. As a reminder, there were two major issues related to Retail Masters going into this meeting. First, we had not been able to reach agreement on an execution plan for Retail Masters although numerous discussions and false starts had occurred. K-Mart had signed a good faith agreement with us in December for which we consented to pay 4th quarter 1992 payments to K-Mart despite the fact our old contracts expired September 30, 1992. And second, K-Mart believes we owe them money. We withheld 1st and 2nd quarter merchandising payments from K-Mart because they did not execute any program changes during the 1st half of the year that would justify payment.

During the meeting we were able to resolve the Retail Masters execution issue. K-Mart agreed to vertically merchandise space to share and equal signage to RJR. We compromised at 7 checklane fixtures for Marlboro versus their offer of 5 and our request of 10. They agreed to expand Basic distribution from 4 items to 11 with rack signage for the Brand. We offered to pay K-Mart 3rd and 4th quarter merchandising payments at the end of year provided immediate (September) communication goes out to the stores with an implementation plan for the 4th quarter. We also advised K-Mart that our payment structure for this performance would likely go down starting January 1, 1994 consistent with competitive (RJR) carton program payment declines.

Unfortunately, K-Mart's agreement to this program hinges on our willingness to pay them for the first half of the year, despite their failure to perform. K-Mart has had a difficult time negotiating concessions from RJR that would allow them to meet our requirements. They have a restrictive contract with RJR that expires December 31, 1994. During the meeting they attempted to accuse us of delaying their implementation, but in reality this just isn't the case (see attached chronology) and they didn't push this point very hard. Rather, they claim they have continued to support us (poorly) as they historically have while trying to negotiate concessions from RJR and should therefore be paid. They have threatened to discontinue PM-USA tobacco products, all tobacco products, General Food items, as well as hold a grudge.

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Our recommendation from a PM-USA point of view is that we not pay K-Mart for the first half of the year. K-Mart does low category volume (180-190 cpw) and low PM-USA volume (60 cpw). They have expressed interest in exiting the category in the past and have indicated that if not for merchandising payments they wouldn't sell cigarettes. Beyond this, they are close to RJR and any Retail Masters concession we make will likely be spread to other customers causing potential trade relations problems.

We think there may be some short term pain from this decision, but that ultimately K-Mart will either exit the category, or try to construct a new merchandising program with all tobacco manufacturers starting the first of the year and they'll want our money when this happens. It's my understanding Glenn Smith may retire at the end of the year (February) so we'll have a new player to deal with.

On the other hand, Antonini could hold a grudge against the food business if we refuse to pay. If we believe K-Mart is important to our food business in the future, this may argue for paying.

Legal believes that the risk if we pay is moderate. The risk is that other accounts, when docked for non-compliance, will find out from RJR or K-Mart's distributors that K-Mart was paid in a similar circumstance and will demand the same treatment (and could be entitled to it).

The cost of paying is \$2.5 mm per half year. I told Glenn Smith it looked to me that we had no basis to make payment, but that I would discuss it with management and we would review it once again legally. I promised to give him a decision by Wednesday, September 15. We parted amicably.

Since this decision has implications beyond PM-USA, I'd appreciate your point of view prior to Wednesday. If we decide not to pay I'll call Glenn Smith and tell him. One of you may want to call Joe Antonini and let him know we've done our best to compromise, but that this is as far as we can go. His people are under budget/bonus pressure that only he can relieve.

Thoughts?

MES/us

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